

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

IN RE:

THE BENNETT FUNDING GROUP, INC.

Debtors

CASE NO. 96-61376

Chapter 11

Substantively Consolidated

RICHARD C. BREEDEN, as Trustee for
THE BENNETT FUNDING GROUP, INC.
and THE PROCESSING CENTER, INC.

Plaintiff

vs.

ADV. PRO. NO. 97-70049A

SPHERE DRAKE INSURANCE PLC, SPHERE
DRAKE UNDERWRITING MANAGEMENT
(BERMUDA) LIMITED,
TRIANGLE INSURANCE MANAGEMENT LIMITED,
LLOYD THOMPSON LIMITED, THE BENNETT
FUNDING CORPORATION, BRIGHTON SECURITIES
CORP., HALPERT AND COMPANY, WEINER ABRAMS
& COMPANY INC., BANKERS FINANCIAL CORP.,
INTERNATIONAL FINANCE BANK, AMERICAN
TRAFFIC SAFETY SERVICE ASSOCIATION, INC.,
SUMMIT FINANCIAL SECURITIES INC., HEFREN
TILLOTSON, INC., HORIZON SECURITIES, SAGE-RUTTY
& COMPANY, MID-STATE ADVISORS, ANDREW
ANDREAS SPECIAL NEEDS TRUST, RICHARD H.
REYNOLDS PROFIT SHARING PLAN, INC.,
SOUTHEASTERN PAPER PROFIT SHARING PLAN,
FIRST FEDERAL SAVINGS BANK OF LAGRANGE,
GREATER DELAWARE VALLEY SAVINGS BANK,
MERCHANTS NATIONAL BANK OF WINONA,
FARMERS STATE BANK, THE COMMERCIAL BANK,
FIRST NORTHERN BANK & TRUST, LAFAYETTE
SAVINGS BANK, DOLLAR CAPITAL CORPORATION,
and JOHN DOES 1 through 10,000

Defendants

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Hon. Stephen D. Gerling, Chief U.S. Bankruptcy Judge

MEMORANDUM-DECISION, FINDINGS OF FACT,
CONCLUSIONS OF LAW, ORDER AND RECOMMENDATION

Presently before the Court is a motion filed on November 18, 1999, on behalf of Sphere Drake Insurance plc and Sphere Drake Underwriting Management (Bermuda) Limited (collectively "Sphere Drake") requesting dismissal of the Third Amended Adversary Complaint ("Third Amended Complaint") as filed by Richard C. Breeden, chapter 11 trustee ("Trustee") in the consolidated case.¹² Sphere Drake also requests that the Court order the Trustee to file a particularized statement of the damages Trustee seeks to recover from Sphere Drake .

By letter dated November 29, 1999, the Court advised the parties that it would treat the motion as submitted without argument as of December 16, 1999. Opposition to the motion was filed on behalf of the Trustee on December 13, 1999, in the form of a Memorandum of Law.

In addition to opposing the relief sought by Sphere Drake, the Trustee asserts that the

¹ On October 29, 1999, the Court entered an Order approving the Trustee's request for leave to serve and file the Third Amended Complaint.

² In a decision rendered on August 6, 1999 ("August 1999 Decision") in connection with this adversary proceeding, the Court recommended to the U.S. District Court for the Northern District of New York that the Trustee's Counts V and VI of the Trustee's Second Amended Adversary Complaint be dismissed as to defendants Lloyd Thompson Ltd. ("Thompson") and Triangle Insurance Management, Ltd. ("Triangle"). A similar order was signed by the Court on January 25, 2000 recommending that the same counts of the Third Amended Complaint be dismissed as to Thompson, Triangle and Sphere Drake. Therefore, the only counts at issue herein involve Counts I and VII of the Third Amended Complaint against Sphere Drake.

motion is untimely because Sphere Drake failed to file a motion to dismiss the Trustee's Second Amended Adversary Complaint. Rule 12(h) of the Federal Rules of Civil Procedure ("Fed.R.Civ.P.") provides that the failure to raise the defense of lack of personal jurisdiction to the original complaint waives the defense, *see* Fed.R.Civ.P. 12(h)(1); however, the defense of failure to state a claim upon which relief can be granted pursuant to Fed.R.Civ.P. 12(b)(6) may be made in any pleading permitted under Rule 7(a) or by motion for judgment on the pleadings or at the trial on the merits, *see* Fed.R.Civ.P. 12(h)(2). Although nowhere referenced in Sphere Drake's motion, the Court will assume that its request for dismissal of Counts I and VII of the Third Amended Complaint is brought pursuant to Fed.R.Civ.P. 12(b)(6), as incorporated by reference in Rule 7012 of the Federal Rules of Bankruptcy Procedure ("Fed.R.Bankr.P."), for failure to state a claim. Although not requested in a motion for judgment on the pleadings or in the context of a trial, in the interest of judicial economy, the Court deems Sphere Drake's motion to be timely and will address the merits of its motion at this time. *See Iseda v. John Alden Life Ins. Co.*, 1992 WL 91944 (N.D.Ill. 1992) at *2.

JURISDICTIONAL STATEMENT

The Court has core jurisdiction over the parties and subject matter of this adversary proceeding pursuant to 28 U.S.C. §§ 1334(b), 157(a), (b)(1) and (2)(A) to the extent that the claims sound in contract or in a declaration of contract rights. The Court has "related to" jurisdiction to the extent that the Trustee's claim is based on negligence.

FACTUAL STATEMENT

Because Fed.R.Civ.P. 12(b) tests the legal sufficiency of a claim, and not its factual merit, a court deciding a motion brought under this rule is limited to a consideration of those facts which appear on the face of the complaint, along with any court documents of which it may take judicial notice. *See Ryder Energy Distribution Corp. v. Merrill Lynch Commodities, Inc.*, 748 F.2d 774, 779 (2d Cir. 1984). For purposes of continuity, the Court incorporates herein the Factual Statement set forth in its August 1999 Decision to the extent applicable to Sphere Drake. The following statement of facts is accordingly drawn from the pleadings of the Trustee. As noted in its prior decision, while these allegations will be construed as true for the limited purpose of this motion, they do not constitute findings of fact by the Court and will not be binding on the parties in subsequent proceedings. *See* August 1999 Decision at 5, citing *ABF Capital Management v. Askin Capital Management, L.P.*, 957 F. Supp. 1308, 1314 (S.D.N.Y. 1997).

1. The Debtors

The debtors in this Chapter 11 case are eight interrelated companies whose bankruptcy estates were substantively consolidated by an Order of the Court on July 25, 1997. The Trustee's adversary complaint was filed on behalf of two of these debtor entities: The Bennett Funding Group, Inc. ("BFG"), whose principal business consisted of originating and assigning equipment lease contracts to investors, and The Processing Center, Inc. ("TPC"), which would service the

leases generated by BFG. It appears, however, that the causes of action which are presently at issue relate to BFG only.

Although BFG had been a legitimate, reputable finance company for the first decade of its existence, the nature of its business underwent a fundamental change in or about 1988. Under the direction of Patrick Bennett, its Chief Financial Officer, BFG began to assign leases which, unbeknownst to the investors who paid for them, had already been assigned to other persons. This deception was made possible, in part, by the intricacies of BFG's lease servicing program, under which TPC would continue to make collections from the lessees on behalf of the investors who had purchased the future lease payments. While each multiple-pledged lease would provide a short-term benefit to BFG, this fraud had the long-term effect of deepening BFG's insolvency since each investor would eventually demand to be paid back in an amount greater than his or her original investment. However, Patrick Bennett was able to escape the immediate consequences of this deception by resorting to the classic expedient of the "Ponzi" scheme-- in effect, paying off these old investors not with the fruits of their investment, but rather with funds misappropriated from new investors. This device could succeed only as long as BFG was able to attract an ever-growing circle of investors, which in turn drove Patrick Bennett to apply his fraud on an increasingly widening scale.

As a result of these practices, by the middle 1990s, BFG had grown into what the Trustee has elsewhere described as "the largest Ponzi scheme ever carried out against individual investors and financial institutions in U.S. history." *Breeden v. Bennett (In re The Bennett Funding Group, Inc.)*, 220 B.R. 743, 747 (Bankr. N.D.N.Y. 1997). The most immediate victims of this fraud were, of course, the thousands of BFG investors and creditors who were left holding millions of

dollars in unpaid obligations when the bubble finally burst in early 1996. The Ponzi scheme also inflicted serious damage on BFG itself, whose business reputation was all but destroyed by the exposure of the fraud. Moreover, by masking the true state of BFG's finances, the Ponzi scheme allowed BFG to continue in the lease financing business long after it had stopped being profitable, thus artificially deepening its insolvency prior to bankruptcy.

2. Sphere Drake

The ability of BFG to draw new victims into its Ponzi scheme depended in large part on BFG's ability to market its securities as conservative, low-risk investments. To this end, Patrick Bennett sought to obtain financial guarantees that would give the Bennett leases the appearance-- though not the effect-- of being insured. Beginning in 1990, Patrick Bennett obtained insurance for various Bennett investments from Assicurazioni Generali S.p.A. ("Generali"), whose relationship with BFG was terminated by 1994. At that time, Generali was replaced by Sphere Drake, a British corporation and one of the world's leading reinsurance companies, as well as Sphere Drake Underwriting, its Bermuda affiliate. Also in the summer of 1994, Patrick Bennett created a "captive" Bermuda insurance company known as Bennett Insurance Co., Ltd. ("BIC"), the name of which was later changed to Capital Insurance. In October 1994, BIC issued its Master Commercial Lines Policy #0001 to BFG, which purported to insure BFG against shortfalls in its lease collections. BIC, in turn, was reinsured by Sphere Drake. Because BIC had only minimal capital reserves, Sphere Drake functioned for all practical purposes as BFG's primary insurer, and further agreed to a "claims paying agent agreement" pursuant to which claims could be made to it directly in place of BIC. Among other provisions, this agreement

contained a choice of law clause which provided that any dispute arising under it would be governed according to the laws of Bermuda.

While it thus might have appeared that the investments sold by BFG had the backing of a large and reputable reinsurance company, a number of hidden clauses in the insurance contracts combined to make Sphere Drake's reinsurance almost wholly illusory. Among these was a "double trigger" clause which set out two conditions that must be met before BIC (and, by extension, Sphere) would become obligated to pay BFG: there would have to be a shortfall in the payments made by the equipment lessees to BFG, and BFG would have to default on its own obligations to its investors. This was significant because, in a typical Ponzi scheme, the Ponzi operator never misses a payment to his investors until the moment when the entire scheme collapses. As a result, in this case, the double trigger ensured that no insurable event would take place prior to BFG's bankruptcy, no matter how badly the leases performed. Secondly, a "fraudulent acts" clause required BFG to reimburse its insurers for any payments made on account of its own fraud. Thirdly, under a "hold harmless" agreement that was added to the claims paying agent agreement in 1995, BFG was obligated to reimburse Sphere Drake for any and all claims paid out under BIC's reinsurance policy. Because BFG was itself the named insured under the BIC policies, the resulting payment obligations were entirely circular: in the event of an insured shortfall, BFG would make a claim against BIC, which would look for payment to Sphere Drake, which would in turn have a right of reimbursement against BFG. This last agreement was kept secret from many of BFG's key officers, including William Crowley, its Chief Accounting Officer.

Sphere Drake was aware of the unconventional nature of this insurance mechanism. In

particular, the fraudulent acts clause was the subject of considerable discussion by high-ranking Sphere Drake officials, including Eric Keen, the Vice President of Underwriting at Sphere Drake Underwriting. Keen expressed his belief that this clause was unenforceable, and worried that the inclusion of the clause suggested that illegal activity was occurring at BFG. In spite of these concerns, however, Keen authorized the inclusion of the fraudulent acts language.

Needless to say, the true nature of this insurance was kept hidden from the purchasers of Bennett investments. On November 2, 1994, Sphere Drake drafted a “Confirmation of Reinsurance,” which stated that it had issued reinsurance to BIC. Copies of this were distributed to investors along with putative “Certificates of Insurance” issued by BIC. Although the investors who received these Certificates were led to believe that they were the actual beneficiaries of these policies, in all but a few instances, the named loss payee under the policy was TPC. The Certificates did not contain industry-standard language stating that they conveyed no legal rights; nevertheless, they were highly effective in attracting investors to BFG.

In his Complaint, the Trustee asserts five separate causes of action against Sphere Drake. The two at issue herein include one for breach of contract, based on Sphere Drake’s failure to make payment under the claims paying agent agreement to BFG and TPC (Count I) for which the Trustee seeks compensatory damages in an amount to be determined at trial; the other (Count VII) seeks compensatory damages as a result of Sphere Drake’s alleged negligence in “failing, during their audits and inspections of BFG’s books and records, to detect the fraud and other wrongdoing committed by Patrick Bennett and his aiders and abettors, and/or in concealing their knowledge of the fraudulent activities” See ¶ 1 of the Third Amended Complaint.

DISCUSSION

This Court has previously enunciated in the proceedings in this case the standard for ruling on a motion to dismiss pursuant to Fed.R.Civ.P.12(b)(6):

The court is to dismiss the complaint only if it appears that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief. *See Gagliardi v. Village of Pawling*, 18 F.3d 188, 191 (2d Cir. 1994). The court should not weigh the evidence but should instead accept the facts as they appear in the complaint as true, to find whether the plaintiff has alleged sufficiently all of the legal elements necessary to state a claim under the law. *See Cosmas v. Hassett*, 86 F.2d 8, 11 (2d Cir. 1989); *Christopher v. Laidlaw Transit, Inc.*, 899 F.Supp. 1224, 1226 (S.D.N.Y. 1995) Based on the foregoing standards, this Court must analyze Plaintiff's Complaint to determine whether he has alleged any set of facts, along with any reasonable inferences which may be drawn in his favor, which are sufficient to entitle him to relief. *See Detko v. Blimpies Restaurant*, 924 F.Supp. 555, 556 (S.D.N.Y. 1996).

See Breeden v. Generali U.S. Branch, et al., Adv. Pro. No.96-70195A (Bankr. N.D.N.Y. Dec. 19, 1997) slip op. at 6 (noting that the standard to be applied in deciding whether to grant leave to amend a complaint pursuant to Fed.R.Civ.P. 15(a) is comparable to that required by Fed.R.Civ.P. 12(b)(6)).

With respect to Count I of the Third Amended Complaint, the Trustee alleges that under the terms of the claims paying agent agreement whereby claims were filed with Triangle and then passed on to Sphere Drake, Sphere Drake agreed in substance to act as a direct insurer for BFG and TPC. *See* ¶ 47 of the Third Amended Complaint. It is the Trustee's position that Sphere Drake acted as the primary insurer for BFG "even though they described their coverage as 'reinsurance'." ¶ 49 of the Third Amended Complaint. Therefore, the Trustee contends that

Sphere Drake is obligated under the terms of the Reinsurance Cover Note to pay BFG and TPC in the event of default in connection with the leases insured by the BFG policy. It is Sphere Drake's position that neither BFG nor TPC were beneficiaries of the Reinsurance Cover Note. Furthermore, Sphere Drake argues that under English law³ even if BFG or TPC were third party beneficiaries, they would have no rights to enforce a contract to which they were not a party.

As was noted by the Court in its August 1999 Decision, there is a question regarding the standards a Bermuda court would apply in deciding the issue of whether "Sphere Drake would be regarded as the direct insurer of BFG leases, rather than as the reinsurer of BIC." *See* August 1999 Decision at 40-41. The determination of this issue directly impacts on the merits of Sphere Drake's position that because there was no privity of contract between BFG or TPC, as the insured, and Sphere Drake, as the reinsurer, Sphere Drake is not liable to either. Therefore, based on the record now before it, the Court cannot conclude that the Trustee would be unable to prove any set of facts in support of Count I of the Third Amended Complaint. *See id.*, citing *Conley v. Gibson*, 355 U.S. 41, 445-46, 78 S.Ct. 99, 102, 2 L.Ed.2d 80(1957). Accordingly, Sphere Drake's motion with respect to dismissal of Count I is hereby denied.

In Count VII of the Third Amended Complaint, the Trustee alleges that Sphere Drake undertook audits of BFG and a review of BFG's books and records for the benefit of BFG in connection with the fact that under the terms of the "hold harmless" agreement BFG was to reimburse Sphere Drake in the event that it was required to make any payments under the BFG policy. It is the Trustee's position that once Sphere Drake, although under no contractual

³ According to the choice of law clause in the claims paying agent agreement, any contract claims arising out of the insurance contracts are to be governed by the laws of Bermuda.

obligation, voluntarily undertook the audits and inspections, it had a duty to conduct them in a proper, skillful, diligent and reasonable manner. The Trustee contends that Sphere Drake breached that duty by failing to detect the Ponzi scheme and/or by failing to reveal to BFG the alleged fraudulent activities of Patrick Bennett.

Similar allegations were addressed by the Court in *Generali*, in which the Court allowed the Trustee to amend his complaint to add a cause of action against the defendant based on negligence. Sphere Drake argues that unlike the defendant in *Generali*, it is only a reinsurer and was under no duty to perform the audits or inspections. While this argument may have merit, if, as Sphere Drake argues, its role was only that of a reinsurer, as discussed above, there is some question whether Sphere Drake was actually more than simply a reinsurer. Under those circumstances, the Court cannot say that it is impossible that the Trustee will be able to establish some factual basis for his assertion that Sphere Drake undertook the audits and inspections for BFG's benefit and breached a duty to BFG. The Court concludes that it will deny Sphere Drake's motion to dismiss the Trustee's seventh cause of action based on negligence and will allow the Trustee an opportunity to establish proof of his allegations in this regard.

Lastly, Sphere Drake requests that the Court compel the Trustee to particularize the amount of damages he is seeking to recover with respect to his tort claims found at Counts V, VI and VII of the Third Amended Complaint. In this regard, Sphere Drake argues that simply stating that compensatory damages are believed to be in excess of \$400 million does not apprise the defendants "of the nature of the damages claimed by the Trustee or permit the defendants to

design discovery against them.”⁴ See Sphere Drake’s Memorandum of Law, filed November 18, 1999, at 10. Sphere Drake relies on *Gordon v. Basroon (In re Plaza Mortgage & Finance Corp.)*, 187 B.R. 37 (Bankr. N.D.Ga. 1995) in support of its request. In that case, as pointed out by the Trustee and acknowledged by Sphere Drake, the form pretrial order used in the Northern District of Georgia required that damages be specified. See *id.* at 44. There is no such form pretrial order applicable to adversary proceedings in this District.⁵

The Court understands some of Sphere Drake’s frustration as it is confronted not only with the adversary proceeding commenced by the Trustee in this court but also with the class action suit commenced against it by investors now pending in the Southern District of New York.

⁶ Unfortunately, at this juncture of the proceeding herein, the Court believes that the appropriate avenue for the relief Sphere Drake seeks is through discovery.

Based on the foregoing, it is hereby

ORDERED that Sphere Drake’s motion to dismiss Count I of the Trustee’s Third

⁴ In its August 1999 Decision this Court found that the damages for which the Trustee had standing to seek recovery were those based on injury to the corporate debtors, namely damage to business reputation, looting and deepening insolvency. See August 1999 Decision at 23.

⁵ Local Rule 7016-1 of the Bankruptcy Court for the Northern District of New York, cited by Sphere Drake as a basis for the Court exercising its discretion and requiring the Trustee to particularize the damages, simply indicates that the mandate of Fed.R.Civ.P. 16(b) requiring a scheduling order does not apply to adversary proceedings in this Court. According to the comment, the Court is within its authority to issue pretrial scheduling orders if it deems it appropriate. Neither the rule nor the comment refer to a requirement that the amount damages be set out with specificity in the pleadings.

⁶ While none of the parties to the adversary proceeding herein have to date sought withdrawal of the reference and transfer to the U.S. District Court for the Southern District of New York, for a number of reasons this Court may consider making a recommendation to the U.S. District Court for the Northern District of New York on a *sua sponte* basis that the reference of this proceeding be withdrawn.

Amended Complaint is DENIED; it is further

ORDERED that Sphere Drake's motion for a particularized statement by the Trustee of the damages the Trustee seeks to recover from Sphere Drake is DENIED; and it is finally

RECOMMENDED that U.S. District Court for the Northern District of New York deny Sphere Drake's motion to dismiss Count VII of the Trustee's Third Amended Complaint.

Dated at Utica, New York

this 3rd day of March 2000

STEPHEN D. GERLING
Chief U.S. Bankruptcy Judge